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The Manufacturers Hanover
Economic Report

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The Trouble With Manufacturing

A funny thing happened to our manufacturing sector two years ago, during the early stages of the current economic expansion. After growing faster than average for the first six quarters of the upswing, factory output flattened in the summer of 1984, and has grown very little since. This comes at a time when manufacturing production, on average, tends to rise some 13 percent. Because factory output accounts for more than a fifth of the U.S. gross national product, its slowdown since the middle of 1984 has cast a damper on overall economic growth. Whereas the real GNP grew 10.5 percent during the first six quarters of the current economic expansion, it has only grown 3.1 percent during the most recent six.

An examination of the data as well as conversations with numerous businesspeople, government officials, and others, has produced some rather startling revelations. U.S. manufacturers are being buffeted by a number of developments, most of which are relatively recent, but several of which have been present for quite some time. To make matters even more serious, many of these do not appear to have a solution close at hand.

Competition From Abroad...

What appears to be bothering the nation's manufacturers the most these days is continued inroads of goods made overseas. The latest statistics on our balance of trade indicate that very little improvement took place in the first quarter compared with the fourth, when the nation's trade gap, as measured in the gross national products accounts, hit a record annual rate of over $113 billion. Coming one year after the dollar peaked in the foreign exchange markets and began a slide which took it down more than 30 percent against a basket of currencies of the countries with whom we do most of our trade, one might have expected more of a narrowing in the trade gap, thus more of a boost to domestic output. This makes allowances, of course, for the J curve effect (Economic Report—January 1986), and for the dollar's strength against the Canadian dollar and the Mexican peso.

With some foreign currencies up as much as 55 percent against the dollar over the past 14 months, U.S. manufacturers have been eagerly awaiting a pickup in their business. They may have a long wait. This is because many foreign exporters are not raising prices as much as their currencies have jumped against the dollar. There are many reasons for this, including a wish to retain share of market in the United States and to remain competitive with other countries whose currencies have followed the dollar downward—most important because of lackluster business conditions in many other industrial countries.

Keeping prices down at a time when their currencies have jumped as much as they have against the U.S. dollar obviously implies quite a hit to foreign producers' earnings. So the question logically arises: do these exporters have the earnings capability to withstand the need to raise selling prices? The answer would appear to be affirmative, because of what foreign exporters failed to do during the period July 1980 to February 1985, when their currencies fell dramatically against the U.S. dollar. Most exporters to the U.S. not only did not lower their selling prices to reflect their cheaper currencies in U.S. dollar terms, some even raised them!

Quite clearly, there was a sizable pile-up of profits which are now available to offset the subsequent rise in foreign exporters' currencies. One would imagine that there will come a time when these foreign manufacturers will exhaust their profit cushion and will have to more fully reflect the rise in the value of their currencies against the dollar when pricing their products in the United States. It is impossible to determine when this will occur, but when it does, U.S. manufacturers will have the opportunity to regain some lost business—provided that they don't match these price increases with price hikes of their own.

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...Fewer Autos And Houses...

Another reason why our manufacturing sector has been languishing stems from the performance of the domestic automobile industry, which accounts for over six percent of factory production. Output of U.S.-made cars peaked back in 1973 at 9.7 million units. They subsequently went on a rollercoaster, dropping as low as 5.8 million units in 1982 before recovering somewhat. However, in recent months output has been averaging barely eight million units at an annual rate. This alone has affected the fortunes of a wide variety of industries such as steel, aluminum, copper, rubber, and glass, to name a few. The steel industry in particular has been affected by other factors besides the reduced number of cars made in the United States. First, the total weight of U.S.-produced automobiles has been shrinking since the mid 1970s. The average car has shed 573 pounds since 1976. What is more, 495 pounds of this, or 87 percent was steel.

The shrinking market for steel's use in automobiles typifies what the steel industry faces worldwide. According to the American Iron and Steel Institute, world production of raw steel in 1984 totaled 782.2 million tons—8.2 million tons below 1980's level and only 36.6 million tons greater than output in 1976. To make matters worse, the share of world production coming from the United States shrank from 17.2 percent in 1976 to only 11.8 percent in 1984.

The U.S. is not alone among industrialized countries in losing share of the steel market. Along with the U.S., output from Canada, Japan, the European Economic Community, and other Western European countries declined from 59.3 percent in 1976 to 50.9 percent in 1984. The big gainers during this time were the developing countries. Brazil has seen its share of steel output go from 1.4 percent in 1976 to 2.6 percent in 1984, while South Korea's share has jumped from 0.5 percent to 1.8 percent. China's contribution went from 3.1 percent in 1976 to 6.1 percent in 1984.

Steel and autos are not the only industries dragging down the manufacturing sector. Many products—either finished goods or components—are no longer made in the United States, but rather, abroad. The chief attraction, besides exchange rates, are low wage costs. This is affecting not only U.S. manufacturers, but producers abroad as well. While Japan, for example, may be picking up market share in the automobile, camera, and consumer electronics industries, they're also losing business in the low-price end of these lines to such countries as Korea, Yugoslavia, and Taiwan. As developing countries gain technological skills, they are increasingly able to produce goods either destined for business use or for consumers since their wage costs remain below those of the more industrialized nations.

...And Reduced Demand For Capital Goods...

If this were not enough, U.S. producers have to contend with a marked change in the capital goods industry. Although rising more than nine percent in 1985, business spending on equipment took a header in early 1986, falling nearly four percent in the first quarter alone. Three factors are at work here. First, capacity utilization remains low. Three and a half years into the current business upswing finds the factory operating rate below 80 percent—the first time this has happened in any postwar expansion that has lasted this long. Second, businessmen's appetites for capital goods have been dampened by tax reform legislation.

The bill passed by the House of Representatives last year would repeal the investment tax credit and sharply restrict the Accelerated Cost Recovery System which allows fast writeoffs. The Senate Finance Committee's version passed early in May would also repeal the investment tax credit although it would retain the ACRS with faster writeoffs except for real estate. Changes in these provisions alone would cost business up to $150 billion per year, and, according to the U.S. Chamber of Commerce, would raise the cost of capital to a company by three percent for three-year equipment and six percent for equipment with a useful life of five years or more. With this sword of Damocles hanging over its head, business has hardly been in the mood to invest in capital goods.

Third, the collapse in oil prices has caused the petroleum sector, which accounts for 9½ percent of total industrial output, to cut back its spending on equipment. This is not surprising when you consider the sharp drop in exploratory drilling, among other things. The petroleum industry alone has slashed projected capital goods outlays for 1986 by $6 billion, or over one-fourth, compared with plans formulated late last year. It would seem that the cutbacks are affecting such oil field equipment as drilling rigs, pipelines, metal containers, industrial machines, motor vehicles—not to mention paper and packaging, chemicals, cleaning solvents, and stone and clay products, most of which are made in the U.S.

This is hurting U.S. manufacturers of capital goods, to be sure. Also hurting them is the fact that they are garnering a smaller share of the capital goods market. In 1965, only 3.3 percent of capital goods bought in the U.S. were imports, according to the Commerce Department. As recently as 1970, imports' share was six percent. However, the combination of the 1980-85 rise in the value of the dollar along with technical innovations overseas and lower wage costs, propelled imports' share to nearly 21 percent last year.

Homebuilding is another area that has changed dra-

matically both in recent times as well as longer term. At the moment, housing is being depressed by conditions in the oil patch and in the farm belt. Multiple dwelling construction has also been affected by concerns over tax reform. The National Association of Home Builders estimates that the Senate Finance Committee's bill would result in a loss of about 400,000 housing starts next year.

Considering that new-home construction is no higher today than it was in 1970, you can see where producers of building materials, home furnishings, etc., have seen their markets stagnate. Add to this the fact that the size of the average home has declined by 127 square feet, or 7½ percent in the last four years alone, and you can see a further diminution in the need for building materials. Not only are single-family houses getting smaller, but multi-unit housing, whose living spaces tend to be less than single-family units, have grown as a proportion of total starts. In 1975, multiple family dwellings accounted for less than one out of every four housing units constructed; last year they reached 40 percent.

...Has Depressed Manufacturing

The commercial end of the real estate market has its problems, too, which impact on manufacturing. The office building boom is apparently over, as demand for office space has fallen precipitously. This comes at a time when commercial builders have put up office buildings at a rapid pace, encouraged by generous tax benefits. Office vacancy rates in most major cities have climbed dramatically in the past few years in response to overbuilding in general, as well as to depressed conditions in the oil patch. Needless to say, this has taken its toll.

Spending on business structures accounts for 4¼ percent of the gross national product, up from 3.6 percent in 1978. Construction of factories and office buildings, warehouses and shopping centers uses up a major chunk of the output of stone, clay and glass, fabricated metals, not to mention a host of other materials, a lot of which is produced in the United States. Outlays for nonresidential structures flattened in the first quarter of 1986 compared with the fourth quarter of 1985. If they do no more than hold steady (and they seem more likely to decline), business spending on structures will rise two percent this year following a jump of over 15 percent in 1985.

Last on the list is agriculture. Depressed conditions down on the farm have caused considerable cutbacks in farmers' purchases of farm machinery, much of which is produced in the United States. Needless to say, they are also buying fewer consumer goods, especially those that are postponable, such as automobiles, furniture and home appliances—again the bulk of which is made in the United States.

As you can see, the nation's manufacturing sector has many problems. Some should diminish in the near future. For example, as foreigners use up their profit cushions and raise selling prices in the U.S., domestic manufacturers will have an opportunity to reclaim their share of market. Oil prices look like they've seen their lows, and if they go up further, some capital spending projects by the important petroleum sector may be restored. And once tax reform is either killed or becomes law, there could be some pickup in capital goods spending since the uncertainties surrounding the exact tax treatment of such outlays will no doubt have been clarified. As for agriculture, farm commodities prices have already bounced up in the wake of the Soviet nuclear disaster, and if they rise further, will boost farm incomes, thus, farmers' buying power.

These are about the brightest spots one can find and they are none too bright. The dark clouds are still present. There doesn't seem to be any letup in the inroads made by foreign automakers in our domestic automobile market. At the same time, U.S. cars will continue to remain small and use less steel than their predecessors. The newly industrializing countries will continue to produce more and more of the goods that used to come mainly from the industrialized world, thanks to the spread of technology and to their lower labor costs. The real estate market does not appear likely to be a major contributor to the manufacturing sector for some time to come.

Some Bright Spots

However, all is not bleak. The fact that the manufacturing sector today accounts for the same share of national output that it did 35 years ago indicates that the U.S. is not deindustrializing as some would maintain. We are not any more of a service economy than we were in the early 1950s. What is happening is that production is shifting—from commodity-type, to high value-added products.

U.S. manufacturers will be able to remain in business if they concentrate on producing goods which require either complicated labor skills and/or high levels of capital investment. The U.S. needs a manufacturing sector in order to be more productive. Since the start of this decade alone output per hour worked in manufacturing industries has jumped by nearly 21 percent, or almost five times that of the economy as a whole. This is not a sign of a dying sector but rather, of a healthy one. This health will become more evident once the temporary problems weighing it down diminish and the longer-term problems are dealt with through technological change, legislation, or economic growth. Until then, we will continue to witness a divergence between factory output and overall GNP growth. H

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The Manufacturers Hanover Westchester Classic will be held at the Westchester Country Club in Harrison, NY, June 2-8, 1986.

- Roger Maltbie, defending champion and other top pros from the PGA Tour, will compete for $600,000 in prize money, and the winner's purse of $108,000.
- Proceeds help support the following area hospitals: United, Lawrence Auxiliary, New Rochelle, Northern Westchester, Phelps Memorial, St. Agnes, St. John's, St. Joseph's, St. Vincent's, Blythedale Children's, Greenwich, Mount Vernon, White Plains, Yonkers General.
- Tickets on sale at all these hospitals through June 1st, thereafter at the gate. To charge with MasterCard or VISA, call 212-808-8519, Monday to Friday, 9am-5pm.
- For more information call (914) 967-5356.

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